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Banks and bankers are by nature blind. They have not seen what was coming… A "sound" banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can blame him.

John Maynard Keynes, *The Consequences to the Banks of the Collapse of Money Values*, August 1931

THE GREAT SLUMP

Recently, Alan Greenspan said: Recessions are difficult to forecast, and therefore difficult to avoid because they were "*driven in large part by nonrational behavior*" such as consumer fears. Considering the consumer's past debt binge, we have the impression that for the first time in many years the consumer is behaving rationally and responsibly. Faced with a rapid implosion of his paper wealth in the stock market, minimal growth in real disposable income and record-high indebtedness, he is, at long last, waking up to the fact that what the fortunetellers on Wall Street have told him about the miracles of the New Economy was nothing but hollow hype. Absurd economic expectations were systematically stoked up to hoist share prices to ridiculous levels.

Reading and re-reading Mr. Greenspan's recent speeches and testimonies, we can only repeat what we have said so many times before: He doesn't have the faintest idea of what is happening, not knowing the why and wherefore. Neither does the pundit consensus. In particular we like the general cry for lower interest rates and more liquidity, as if Mr. Greenspan has spent the last year or so standing on the monetary breaks when, in fact, he has presided over the worst financial excesses in history and the creation of grotesque imbalances. What we are observing and witnessing in the United States is crystal-clear: The Great U.S. Bubble is bursting. That is behind the violence of the slump, and that is sure to make for a prolonged "L" recession. Confidence is, of course, all-important. But such a shattering fall in confidence, as is presently occuring in the United States, does not happen without hard causes. The U.S. economy has them in plenty.

It's all too familiar from past experience: Historically, the big and protracted economic slumps have occurred when credit excesses have primarily fuelled excessive consumer and investment spending, either in real estate or industrial plants, because their corrections may stretch over long periods. In the last letter, we spoke of "post bubble" recessions. The most important thing to realize about the U.S. economy is that the excesses and imbalances that accumulated during the past few boom years are the worst in history.

In short, the pattern and extent of the boom determine the pattern and the extent of the following downturn. In his congressional testimony on Jan. 25, Mr. Greenspan stated that the current economic slowdown in the United States probably belongs to the garden-variety type involving chiefly a "*major inventory adjustment.*" Yet he added the warning that a "*breach in consumer confidence*" was his main concern. We are tempted to console him by saying that a mere inventory correction is not prone to do that. Besides, considering his endless eulogies on the U.S. economy's new paradigm health and strength, we wonder what is making him so fearful. His own confidence appears very fragile.

During his testimony, Mr. Greenspan actually returned to his familiar theme: "*Because the extent of the slowdown was not anticipated by business, it induced some backup in inventories, despite the more-advanced just-in-time technologies that have in recent years enabled firms to adjust production levels more rapidly to*

changes in demand." Yet a few sentences later he draws the exact opposite conclusion that *"a round of inventory rebalancing appears to be in progress. Accordingly, the slowdown in the economy that began in the middle of 2000 intensified, perhaps even to the point of growth stalling out around the turn of the year… New technologies for supply-chain management and flexible manufacturing imply that businesses can perceive imbalances in inventories at a very early stage—virtually in real time—and can cut production promptly in response to the developing signs of unintended inventory building.*"

Please take note: In the first sentence, Mr. Greenspan explains that the "*advanced just-in-time technologies*" have failed to prevent an unintended inventory build-up. A few seconds later, he points out that the new technologies enable businesses to recognize inventory imbalances at a very early stage, so that production is cut more promptly than in the past. And therefore the stunning speed of the economy's downturn.

NEW ECONOMY—NEW RECESSION?

It strikes us that Mr. Greenspan wants to push an idea that happens to also be Wall Street's latest fad. It's the idea that the U.S. economy is now experiencing a new kind of downturn—one driven by vastly improved information flows. It says that the new information technology allows companies to sense and respond more quickly to changes in market conditions. This explains why the economy's downturn has happened with such unusual suddenness and rapidity. But for the very same reason, it helps to avoid prolonged economic weakness because policy actions, whether tax cuts or interest rate cuts, are equally prone to sink in much faster than in the past.

Manifestly, Mr. Greenspan and Wall Street want to convey the impression that the unusual speed of the U.S. economy's downturn gives no cause for worry but owes largely to the circumstance that the new technology has immensely quickened necessary adjustments of economic and financial imbalances, and that this should be regarded as generally beneficial for the economy's future performance. The only danger is that such concerted, rapid response may shake confidence and trigger unreasoned caution. But sleep well. Thanks to Mr. Greenspan's vigilance and more aggressive rate cuts, this is most improbable to happen.

As he said:

> *It means that those imbalances are not allowed to build until they require very large corrections… As a consequence, firms appear to be acting in far closer alignment with one another than in decades past. The result is not only a faster adjustment, but one that is potentially more synchronized, compressing changes into an even shorter time frame.*

As a result, the present economic downturn will find its bottom much sooner than those in the past. Aided and abetted, moreover, by the Fed's more rapid and more generous rate cuts and liquidity injections, the blessings of the upside will arrive equally faster. In due logic, the Fed and the happy consensus are forecasting economic growth as a whole of 2-2.5% for 2001, implying a boom-like rebound in the second half of the year. While the recession has barely started, for the markets it is already a thing of the past. It has a new theme to play: America's impending "V-shaped" recovery.

We have pinpointed these utterances from Mr. Greenspan about what type of recession he sees unfolding in the United States for two reasons: *first of all*, understanding the nature and pattern of the downturn is a question of utmost importance, and *second*, the easily checkable facts flatly belie what he says. It's definitely not a garden-variety inventory-driven recession. Pronounced economic weakness is everywhere, except in business inventories and government spending. The inventory-to-sales ratio, a key gauge of whether inventories are outpacing sales, rose to a 19-month high of 1.36% in November, after growing at an average pace of 0.6% in

the prior six months. There was a slowdown to a rise of 0.1% in December. By the way, that is well below the pace that the Commerce Department had assumed in its fourth-quarter GDP report. The inherent implication is obvious: The big inventory drag on production and real GDP growth has yet to happen.

The key factors behind the downturn are slumping consumer and investment spending. The question is not what will trigger a recession in the United States, but what will stop the snowballing of the downturn already under way.

LIES, MORE LIES AND GREENSPAN SPEAK

To repeat: Assessing the potential and probable severity of the current economic downswing in the United States requires monitoring its specific pattern in the first place. As we have repeatedly explained, the typical and also the most harmless kind of recession is an inventory correction. It is also the one that implicitly leads to the coveted "V-shaped" recovery. Mr. Greenspan and Wall Street have zealously grasped at the notion that this downswing must be of this benign kind. Wishful thinking reigns supreme. It doesn't bother them in the least that the official GDP statistics flatly contradict this contention. Inventories have not only held up during 2000, they have boomed.

Mr. Greenspan keeps raving about the marvels that better and faster information is doing to the U.S. economy's efficiency and productivity. In his view, apparently, information technology is everything. Therefore, there can never be too much of it. We have always considered this a gross misjudgment that puts economic reason on its head, because information is, in essence, production's "servant."

With this caveat in mind, please consider that business investment in Information Technology—measured, though, in fictitious, hedonic dollars—soared by $110.6 billion in 1999, accounting for 82% of total fixed, nonresidential investment. Investment in industrial equipment, by comparison, increased by a little less than a billion dollars, accounting for less than one percent of corporate fixed investment. Mr. Greenspan's ability to identify an "imbalance" has its obvious narrow limits.

In contrast to the Fed Chairman, we distinguish strictly between *available information* and *actual knowledge*. What matters, and matters only, of course, is the use that is made of available information. Numerous incidents suggest to us that proper use is badly lacking. Take the gross misinformation about the current U.S. economic downswing. While the official statistics clearly reveal zero inventory correction until late 2000, Mr. Greenspan and the pundit consensus refuse to take notice, trumpeting instead what the bullish community wants to hear: Making the V-sign, they speak of nothing but an inventory recession. And just as remarkably, there is not one voice of dissent to be heard. Comprehensive, detailed analysis of the facts is completely lacking.

Or think of the belated recognition of the current downswing. It was only Nov. 15 that Mr. Greenspan & Co. concluded that the risks in the U.S. economy were skewed towards overheating and higher inflation. A mere seven weeks later, on Jan. 3, he made his panicky, unprecedented 50-basis point inter-meeting rate cut to prevent a collapse of confidence. And another three weeks later he already sees a bottoming economy. If Willem Duisenberg of the European Central Bank had performed such U-turns in such a short time after having made such a hash of his outstanding ability to read the tea leaves, he would have been ridiculed with calls for his head.

It is true, all the same, that America has the highest inflation rate among the industrial countries, for consumers presently at 3.7% compared to a year ago. Unit labor costs, a key gauge of inflation pressures, rose at an annual rate of 4.1% in the fourth quarter, sharply up from 3.2 % in the previous quarter. In so far, the Fed's

inflation worries were all too well founded. But—like most of Wall Street—they were blind to the economic downswing that was unfolding with a vengeance. It's stagflation, really.

FACTS AND FIGURES

Now to the facts and figures of the U.S. economic downturn. Take a look at the table below. Three aggregates clinch the matter: fixed capital investment, consumer spending and business inventories.

CONTRIBUTIONS TO REAL GDP GROWTH IN PERCENTAGE POINTS (ANNUAL RATES)

	1999	1999	2000			
		IV	I	II	III	IV
GDP percent change	4.2	8.3	4.8	5.6	2.2	1.4
Personal consumption	3.52	4.08	5.03	2.14	2.99	1.92
Durable goods	.96	1.04	1.79	-0.42	0.61	-0.28
Fixed investment	1.53	1.26	2.68	1.93	0.55	-0.30
Nonresidential	1.26	1.22	2.54	1.87	1.02	-0.20
Structures	-0.05	0.29	0.63	0.14	0.44	0.30
Equipment	1.30	0.94	1.91	1.73	0.58	-0.50
Residential	0.27	0.03	0.14	0.08	-0.47	-0.10
Inventories (in $billion)	45.3	80.9	36.6	78.6	72.5	67.0
Net exports	-1.03	-0.37	-0.94	-1.00	-0.90	-0.56
Government spending	0.59	1.50	-0.18	0.85	-0.24	0.50

Source: Department of Commerce, Survey of Current Business

The most important point to note in the table is the behavior of inventories. Far from being the driving force behind the downturn, the inventory cycle has until year-end been the major support for the economy, in particular for manufacturing.

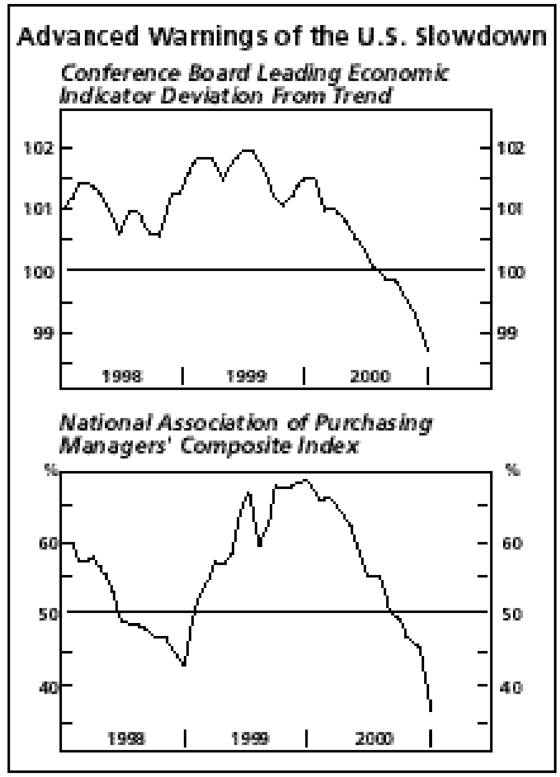
In this light, the downturn's stunning speed must appear all the more ominous. The precipitous slump is in *final sales*. Their growth has plunged in the course of 2000 from more than 6% to less than 2%. That's an extraordinary deceleration. But as earlier explained, Wall Street offers a highly positive interpretation by ascribing it to the "time-compressing" effects of the new information technology. Everything happens much faster than in the past. In our view, such "time compression" ought to have shown first of all in inventories. But that's precisely where it did not show.

In actual fact, several indicators have given advance warning of the unfolding slowdown already since late 1999. Both the Conference Board's leading economic indicator and the index of the National Association of Purchasing Managers have been performing a vertical decline. But the hype about the New Economy overwhelmed any critical observation.

Given the many unusual aspects of the downturn, one would expect a soul-searching discussion about its underlying causes. Yet there is absolute silence on this question and the unanimous mantra is that the economy is stalling primarily due to the Fed's immoderate monetary tightening between mid-1999 and mid-2000 and the simultaneous surge in oil prices.

THE CREDIT BRAKE IS ON

We strongly dispute both arguments. Any talk that the economy has been strangled by monetary tightness is bare nonsense. The sheer money and credit numbers for the last two years show very rampant money and credit expansion. As we explained and demonstrated with several charts in the last letter, 1998 was really the



crucial inflection point in the U.S. economic and financial boom as, according to all evidence, the situation got completely out of control. The three rate cuts in October/November of that year by .75 basis points altogether, in actual fact, propelled the excesses and imbalances in the economy and its financial system to new extremes. Personal saving, to mention one striking example, took its steepest plunge ever with a decline from $265 billion in 1998 to -$57 billion, at annual rate, in the fourth quarter of 2000. To speak of undue monetary tightness in the face of this fact is simply ludicrous.

Not only that, Mr. Greenspan and his playmates have grabbed every possible and impossible opportunity to aggressively flood the financial system with liquidity—think of the LTCM debacle and the Y2K fright. It is nevertheless true that the credit expansion has sharply slowed in the course of last year—with obvious strong, restraining effects both on the stock market and the economy. Nonfinancial debt was up in the fourth quarter of 2000 by merely 3.9%, annualized. That's the lowest rate of credit expansion since the 1990-91 recession. It ran at 9.6% in 1998, 9.5% in 1999 and comes from 9.8% in the second quarter and 6.8% in the third quarter of 2000. An even sharper slowdown has occurred in the borrowing of the financial sector. After running in excess of $1 trillion in 1998 and 1999, in 2000 it has lately declined to $700 billion at annual rate.

So much for the facts. After all, the credit brake is on. But—more importantly—who or what has pulled it? Ever since Milton Friedman and Anna Schwartz published their *Monetary History of the United States* in 1963, for most American economists it is dogmatic, *first*, that monetary policy is all-powerful and, *second*, that the central bank, as the ultimate supplier of liquidity to the financial system, can virtually produce any desired increase in the money and credit supply. It's a conceptual picture that gives little or no weight to the decisions of banks, investors and even the borrowers. Weak balance sheets or negative profit and income expectations, restraining demand for credit, play no role.

That may be true most of the time. But history has shown that there are times when factors other than the central bank play the governing role in the credit system, and we are furthermore sure that the present is such a time. Considering ravaged balance sheets of consumers and corporations and drastically diminished profit and income expectations, the two have obvious reasons of their own to retrench their borrowing and spending.

Just a brief remark about the supposition that higher oil prices have also played an important role curbing U.S. economic growth. If that's true, it begs the question, why not in Europe? But investigating this premise, we made another interesting discovery. America has been the one lucky country in the world that had no import price inflation last year. Import prices fell even a bit more than export prices. Certainly largely due to the strong dollar, the rise in imported oil prices was offset by falling prices of other imported goods. Ergo, import prices, including higher oil prices, were no factor in slowing the U.S. economy.

In Europe, in diametric contrast, a steep rise in import prices, due partly to higher oil prices and partly to the weak euro, has massively squeezed domestic purchasing power and hence real income growth. In Germany

alone, for example, this drag amounted to about DM 40 billion last year, or about 1% of GDP. Obviously, this dramatic deterioration in the terms of trade was a major negative for economic growth in Europe, but it has been widely overlooked because the conventional GDP calculation in real terms, implicitly, disregards any effects in nominal terms. The only effect that shows is the price-adjusted export gains, being customarily hailed as the great beneficial effect of a falling currency.

GAUGING THE DOWNSIDE

Back to the question of the pattern and nature of the U.S. economy's present downturn and its implications for the depth and duration of the downside. It strikes us that despite the rising tide of bad news, the forecasting fraternity in America is still not predicting anything worse than a 2–2.5% soft landing for 2001, implying a brief downturn in the first half to be followed by a sharp recovery in the second half. Obviously, they share Mr. Greenspan's view that this is a harmless short-run inventory correction.

Referring to the GDP statistics, we can only repeat that that judgment is completely out of place and misleading. What the figures bear out are definitely two things: a broad collapse in consumer spending on everything except for essential services and a precipitous decline in capital spending. Capital goods orders have collapsed. Media companies are pulling the plug on one e-venture after another. Businesses are slashing their Information Technology budget. That's clearly not an inventory recession. The full extent of any overhang on the supply side is never known until after the fact. According to Federal Reserve data, increases in tech capacity have been running for several years at a 35-45% annual compounded rate of growth. In December 2000 the rate of growth was nearly 50%. Persistent demand growth at this rate is hardly feasible.

Realizing these facts begs the next question: what has caused this sudden, sharp retrenchment both by consumers and corporations? Again, the consensus has a ready, comforting conclusion. It's excessive monetary tightness, implemented by the Fed's 175 basis points rate hikes between mid-1999 and mid-2000. Remove some of that restraint, according to the popular theory, and the economy will take off again.

Even "post bubble" recessions, though, may considerably differ. The U.S. recession of 1990-91 originated mainly in the real estate bubble of the late 1980s. Japan's endless recession is rooted in vast excesses in real estate and industrial investment during the late 1980s. But what and where are the unsustainable excesses whose unwinding will drive the U.S. "post bubble" recession of 2001 and the following years?

As far as the real economy is concerned, the worst spending excesses definitely took place in high-tech investment and in consumer durables. To all appearances, the overspending in these two areas went together with gross underinvestment in the manufacturing sector of the Old Economy, which is a main reason for the soaring trade gap.

For many it is a comforting thought that excesses in capital spending in the United States are far more moderate than in the case of Japan. That's certainly true. But there is one thing in which the present U.S. bubble compares most atrociously with Japan's bubble, and that is in the inordinate involvement of the consumer, showing in particular in three features: heavy participation in the stock market speculation, soaring indebtedness and the steep plunge of his saving rate into negative territory. This trio of extreme consumer excesses has no precedent in history. During Japan's bubble period, the consumer kept rather aloof. There is a vague resemblance only with the American bubble in the 1920s, in that private households discovered debt and took part in the stock market speculation. But measured against the monstrous credit excesses of recent years, it was rather tame.

Assessing the inherent dangers for the U.S. economy, the bursting of the high-tech bubble appears extremely

important for psychological reasons. High tech and the religious belief in its miraculous economic effects were crucial in creating the whole New Economy hype which, in turn, inspired the borrowing and spending excesses. If that hype is shattered by some adverse economic event, the U.S. economy and its financial system may collapse like a house of cards. And this possibility is certainly the true concern of Mr. Greenspan. It is not about confidence, it is about New Economy hype.

From a strictly economic perspective, the negative personal saving rate in combination with record-high debt levels certainly represents the greatest threat. Economic reason demands that this dangerous imbalance ought to be stopped and reversed. But the unsavory fact is that even a modest rebound in the saving rate would be enough to send the U.S. economy into recession, with incalculable economic and financial consequences.

CONFIDENCE VERSUS HYPE

Some people are worrying that Mr. Greenspan might ease too much again, unleashing a new burst in consumer and business demand, triggering new overheating. We think this risk is not only remote, it is non-existent because we doubt the effectiveness of monetary easing in this environment. What needs explanation in the first place is why economic activity came so sharply off the boil. It definitely had causes other than tight monetary policy, and there was not a sudden, exogenous shock.

Recently we have been reading a book titled *Major Recessions*, written by a distinguished British economist, Christopher Dow, formerly assistant secretary general of the OECD and executive director of the Bank of England. Attaching overriding importance to swings in confidence, he writes: "*The first stage of the U.S. recession (in 1930) seems inexplicable except as a swing in consumer and business confidence… The rapid expansion was bound to be checked some time. There followed in 1930 a big fall in consumption, a very big fall in fixed investment, and a big fall in stocks. These abrupt falls in demand fully fit the hypothesis that there was a large downward shock to expectations of a sort that is likely to follow an excessive boom; they are indeed difficult to explain on any other hypothesis.*"

In our view, this description perfectly fits what has happened in the second half of last year in the U.S. economy. Speaking of confidence, it is necessary to distinguish between reasonable confidence and unreasonable overconfidence, or hype. What the flood of bad economic news has quickly shaken is the former naïve belief in future economic miracles that Wall Street and Mr. Greenspan have systematically whipped up. All of a sudden, there is gross disappointment everywhere: about profits, about income growth, about stock prices and wealth. If anything astonishes us under these circumstances, it is the stellar growth performance that Mr. Greenspan and the forecasting community continue to predict.

In the last letter, we drew the distinction between the typical, short-run inventory recession and a protracted "post bubble" recession requiring a protracted retrenchment in consumer and investment spending. We pointed out that the 1990-91 recession was the first one of this kind in the whole postwar period and that it took several years of very low interest rates and economic and financial adjustment to restore satisfactory economic growth.

The present U.S. economic downturn is manifestly of that same type. Nevertheless, there are substantial differences. They can be summarized in one short statement: Excesses and imbalances, strangling the U.S. economy and its financial system, are incomparably worse this time than in 1990-91.

Just to mention a few of those differences: In 1990-91, consumers still saved 8.3% of their current income. Also, in 1990 the current account of the balance of payments was with $76.9 billion in deficit, but it is currently with $450 billion. Consumer debt has almost doubled, while business indebtedness is up 70%.

Two particularly threatening features that were non-existent in 1990-91 but are still present now are the

pathologically inflated corporate equity market and unprecedented leverage of consumers, businesses and the whole financial system. In 1990, mortgages amounted to about 35% of the value of houses. Despite a further substantial rise in the value of houses, this percentage is now nearly 50%. Leverage-related borrowing by the financial sector for the purchase of financial assets has more than trebled, from $2.6 trillion to $8.1 trillion, during the past 10 years.

While the recession of 1990-91 largely reflected the unwinding of the prior real estate bubble, the present economic and financial situation involves excesses and imbalances across the whole economy and its financial system of a size that is unequalled in history. They essentially imply that the U.S. economy must undergo wrenching structural changes.

THE MOST OBVIOUS, GREATEST THREAT…

Earlier we said that the collapse in personal saving is the most obvious, greatest threat to the economy. In the fourth quarter of 2000, the saving rate was -0.8% of disposable income. That was down from 1.5% in the fourth quarter of 1999, and from 3.8% a year before that. Considering the looming, disastrous ramifications, it urgently needs a closer look.

In *Business Week*, on Feb. 26, 2001, we read under Economic Trends: "*It turns out the rate hasn't plunged.*" The article reported about a recent study from the Federal Reserve of New York that supposedly confirmed what most economists already suspected: that the Commerce Department's official gauge of savings "*is a 'very distorted measure'of consumer finances that doesn't say much about Americans' ability to keep on spending.*"

According to the study, the government statistics undercount both personal income and personal saving because they exclude gains or losses from the sale of assets. The authors propose to include realized capital gains in the personal income and savings figures. In that case, the savings rate would be 7.25 percentage points higher than reported. Moreover, the rate didn't drop much throughout the 1990s, painting a much more optimistic picture. It's hard to believe that such superficiality appears in the publication of a central bank.

We realize that this is a widely held view among American economists. Neither the facts as such nor their disastrous long-term implications find any attention. In actual fact, there are two different, equally important aspects to it. The one is macroeconomic and concerns its impact on the allocation of resources in the economy; the other one is microeconomic and concerns its impact on the balance sheet of private households.

As to the macro aspect, saving is the indispensable condition for capital formation. Creating capital is feasible only to the extent that people keep their consumption below their net income. What happens is that this abstention from the consumption of a part of current income releases productive resources for the production of capital goods. Conversely, a decrease in saving is therefore tantamount to a reduction in the supply of capital goods, inherently implying capital consumption.

There is a widespread view that America doesn't need domestic saving because it has abundant capital inflows. First of all, we would say that the foreigners in general don't build new factories in America. They buy existing ones. In other words, these capital inflows add virtually nothing to America's productive apparatus. The one and only thing that the foreigners do build in America is ever higher claims on future American income. In 1983, the United States had a net foreign investment income of $36.5 billion. In the last years, this investment income balance has been soaring into the red, approaching -$60 billion this year. In actual fact, America's foreign indebtedness is increasing much faster than its domestic, physical capital stock.

What's happening here is really a pretty ugly thing. Americans are selling their factories to boost their

consumption. For very good reasons, American policymakers are desperate to preserve the strong dollar. It is the indispensable condition to keep this process going. But the true choice is only between immediate or later, even greater, disaster.

So much for the dismal macro aspect of the saving collapse; now to the micro aspect, which is no better. First to the facts and figures.

Looking at the atrocious income, debt and savings figures of private households in the table below, we see a consumer who is completely tapped out financially, and that it is high time to stop his reckless borrowing. It has lasted much longer than we ever thought possible, but the result is a consumer whose financial situation is desperate.

PERSONAL INCOMES, EXPENDITURES AND SAVING

	1998	**1999**	**2000**					
			QI	**Q2**	**Q3**	**Oct.**	**Nov.**	**Dec.**
Income*	4.8	3.2	1.9	3.7	2.6	-0.5	-0.1	0.2
Expenditures**	4.7	5.3	7.6	3.1	4.5	0.1	0.1	0.1
Debt growth in %	8.8	9.0	8.1	9.7	8.2			
Personal Saving***	4.2	2.2	0.2	0.3	-.02	-0.7	-0.9	-0.8

*Increase in real disposable income in % of chained dollars, annualized
** increase in % of chained dollars, annualized
*** changes in the rate of personal saving as % of disposable income *Source:Department of Commerce, Survey of Current Business*

The table above also reveals something of great importance that has attracted very little attention so far. There was dramatically slower growth of consumer incomes and consumer spending during the second half of last year. However impressive the monthly employment numbers the government releases look, the fact is that the total hours worked in the non-farm sector have been growing at their slowest rate in more than four years. Third-quarter income figures are, by the way, heavily inflated by a big lump payment of subsidies to farmers. Another thing to keep an eye on is, of course, the consumer's soaring indebtedness. They call that tight money.

The important, critical point to see is that the consumer has not at all retrenched. With real income growth almost vanished, any further rise in consumer spending depends on dipping deeper and deeper into savings and debts. But the prior nosedive of the saving rate in the fourth quarter has already given way to a near-stagnation.

… AND ON TOP A CAPITAL SPENDING SLUMP

Again, facts and figures first. Please take another look at the table on page 4 of this letter, showing the changes in the composition of GDP growth. In the first quarter of 2000, fixed investment accounted for 53% of real GDP growth and even for 90% in the second quarter. In the fourth quarter, it was so far down that it subtracted from GDP growth. Again, it has to be said that a slowdown in capital spending was to be expected, but the speed at which it has materialized is stunning.

Until a few months ago, it was a strict article of faith for the believers in the New Paradigm economy that outlays on high-tech equipment were virtually immune to the business cycle, as relentless competitive pressure would force corporations to maintain this profit-enhancing capital spending. Ironically, it is proving the one component that is getting hit hardest in the whole economy. One after the other, even the established stalwarts of high-tech production are now telling horror stories about rapidly shrinking order books and profits. The deluge of cheap capital of the past several years has led to a technology glut of epic proportions.

In our view, this developing disaster in the high-tech sector is not just a cyclical correction. At bottom, it

is rooted in the fact that the economic miracles generally attributed to the new Information Technology are far more hype than reality. Putting it into plain language: most of the new paradigm in the U.S. economy was and is statistical distortion and illusion.

It has been hailed as a hallmark of the New Economy that capital spending in the United States has soared to its highest ratio of GDP in decades. We have been asked us many times: How can a country have such an investment boom even with negative personal savings? The answer: It can't.

The illusion begins with the fact that these numbers relate to gross investment before depreciation. Rising gross investment boosts GDP growth. What matters for income and profit creation, however, is net accumulation of capital after depreciation. Net investment, and net investment only, adds to the nation's capital stocks and creates additions to incomes and profits. While the GDP statistics, expressed in "chained" dollars, show an explosive rise in gross capital expenditures, there has been very little concomitant follow-through in net investment and the growth rate of the capital stock. And the reason for that is obvious: a dramatic shift in the pattern of investment away from long-lived investment to short-lived investment, implying rising depreciation charges and, as a consequence, the need for ever-higher gross investment just to maintain the existing capital stock. It has been calculated that replacement now makes up about 75% of gross investment in total equipment and software, up sharply from a 50% portion in the past.

It's obvious what lies behind this dramatic shift in capital spending's lifespan: the well-known shift away from investment for higher output towards investment for improved information. Still, few people seem to realize the vehemence of this shift. In 1999, for example, fixed, nonresidential capital spending amounted to \$115 billion, which accounted for 32% of real GDP growth. But no less than 91% of that increase in investment expenditures went into computer hardware and software. Note further that "real" spending on computer hardware, treated by the hedonic price index, amounted to \$68 billion, as against an increase in current dollars by a mere \$9.4 billion.

THE TWO KEY TESTS

Capital spending owes its paramount importance as a source of economic growth to the fact that it impacts the economy both from the demand side and the supply side. As capital goods are produced, this adds to output, employment and incomes. As the production is completed and plant and equipment installed, this adds later to potential supply in the economy, involving partly higher productivity.

It was an important particularity of the industrial technology that it had big effects in both respects. Producing the necessary plants and equipment required in general a massive input of capital, labor and material propelling economic growth vigorously from the demand side. No less substantial were the resulting productivity effects propelling economic growth from the supply side.

How does the information technology compare by these two tests? In short, most miserably. Because the production of this equipment involves very little input of labor and material, it has very small employment and income effects to begin with. That's the big negative concerning the demand side. All the more hype is made about its tremendous supply side effects, otherwise called productivity growth. Mr. Greenspan implores it as compelling proof that the New Economy still exists. Yet the wage earner looks for it in higher wages, the businessman in higher profits. Both are looking in vain, Mr. Greenspan.

A PROFITLESS TECHNOLOGY

Reflections about the specific macroeconomic effects of IT technology long ago led us to the conclusion

that it is doomed to lacking profitability. Many American economists seem to regard as its great advantage that it offers more and more power for less and less input and costs. Although it appears a paradox, in reality this is precisely the main reason for its low profitability.

It is a widely unappreciated fact that net capital spending is typically the most important profit source in a capitalist economy. To answer the question where profits come from requires a macroeconomic perspective. When a firm invests in plants and equipment, it augments business revenues in the aggregate. It has been particular to the industrial technology that capital investments, often with a long lifespan, generally involve a massive input of capital, labor and material. But the most important point about this technology from the point of profit creation is that the investment's costs are capitalized in the balance sheets. No expense is occurred until the first depreciation charge is recorded. In other words, it is high investment costs that make for high profits.

With these positive implications for the industrial technology for profitability in mind, let's now take a look at the information technology. As is easy to see, its qualifications are in every single respect the exact opposite to the industrial technology. Production capacities come quickly on stream. The production of the equipment requires very little input of labor and material. What's more, the generally short lifespan of this equipment implies quick, profit-reducing depreciation. In short, this technology has everything that makes for low profitability.

Wall Street has convinced global investors that massive application of the new information technology and a managerial revolution that emphasizes downsizing and restructuring as a means to raise the rate of return on capital have turned Corporate America into the world's greatest profit machine. The truth is that the unusually rapid growth in earnings between 1991-95 chiefly reflected a sharp fall in interest costs that had everything to do with Mr. Greenspan and nothing to do with a managerial revolution. Ever since, corporate profits have been boosted far more by firms' stock market activities—through extensive use of stock options, realized capital gains and funding of pension plans by stock market gains—than by their regular activities. Even then it needed additional gimmicks, such as the focus on profits per share and expected profits, to fabricate profit growth that appears sufficiently impressive for investors. A closer, critical look at profits and their source makes it patently clear that it has in reality been rather less than mediocre.

Weighing the profit outlook, it has to be considered that they are hit by a double whammy. One comes from the weakening economy, and the other one comes from the total disappearance of the former, big financial gains accruing from the booming stock market. That's why we share the horrible profit forecast of the Levy Institute:

"Earnings will be worse than expected in the first quarter. They will be much worse than expected in the second. And rather than recovering, they will in all probability nosedive in the second half… 2001's fourth-quarter earnings decline could be the steepest in postwar history. And 2002 may be scary."

DEFIANT DOLLAR

The great surprise in the whole development is and remains for us the resilient dollar.

It seems to defy gravity considering that a slowing economy and falling interest rates are the typical harbingers of a falling currency. In the United States, there is an unusually sharp slowdown that has provoked very aggressive rate cuts, and both are happening on top of a monstrous current-account gap requiring incessant huge capital inflow. It is impossible to conceive of a more forceful case for a falling currency. The dollar crisis is an accident waiting to happen. A deep, prolonged recession is that accident.

It started to work, indeed, in the last weeks of 2000. But paradoxically, it stopped soon after the Fed's rate cut on Jan. 3. A rate cut that would normally have weakened the dollar strengthened it instead. It seems obvious

what thwarted the rule: the Greenspan Put. Never mind the impending, shallow recession. The one and only thing that matters is the "V"-shaped rebound in the second half.

We regard the dollar as the benchmark of the still prevailing confidence in the U.S. economy's viability. Resumption of its decline would signal disaster for the stock market.

CONCLUSIONS:

Mr. Greenspan and the Wall Street fraternity are trying desperately to prevent the economy's sudden, sharp slump from wrecking the confidence in the New Economy. Forever expecting a miracle, the focus is now on drastic interest rate cuts as the great savior that will revive the credit excesses.

For the time being, they have been quite successful. There is concern about the immediate future, but many seem to perceive the future still in a very positive way. That will change.

An unappreciated chief cause behind the bear market in stocks is the cessation of the formerly huge corporate stock buybacks.

The global bear market in stocks continues unabated, ravaging perceived financial wealth and market liquidity. Widening credit spreads and a weakening dollar are creating a confluence of self-feeding forces. On balance, the U.S. economy clearly emerges as the weakest link in the world economy.

If Mr. Greenspan believes that the downturn comes from irrational behavior, it appears to us that the American consumer is for the first time in many years behaving rationally by retrenching.

It is a great mistake to believe that the U.S. asset bubble has only been in technology stocks and the high-tech sector. The fact of the matter is that they are but one critical component within the Great U.S. Credit Bubble. The yet unappreciated key point to recognize is that years of incredibly reckless credit excess have pervaded and grossly imbalanced the whole economy and its financial system.

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